BANK OF ENGLAND
LONDON EC2R 8AH

23 March 2009

The Rt Hon Alistair Darling
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Chancellor,

Tomorrow, the Office for National Statistics (ONS) will publish data showing that CPI inflation rose to 3.2% in February. That is more than one percentage point above the target. As a result, I am writing a further open letter to you on behalf of the MPC.

By convention, the public exchange of letters between us takes place at 10:30am on the day the inflation rate is published. However, on this occasion, the publication of CPI coincides with my appearance before the Treasury Committee. As such it had been agreed with the ONS and H.M. Treasury that the letter would be published at 9:30am tomorrow, in order that I might refer to its content in my evidence.

Our remit specifies that we should explain why inflation has moved away from the target, the period within which we expect inflation to return to the target, the policy action that the Committee is taking to deal with it, and how this approach meets the Government's monetary policy objectives.

Why has inflation moved away from the target?

Over the past two years, inflation has been noticeably more volatile than in the previous decade. My previous letters in June, September and December explained that most of the rise in inflation in 2008 was associated with developments in commodity prices, particularly those of food and energy.

The effects on UK retail prices of increases in these world prices were magnified by the sharp depreciation in the sterling exchange rate.

Since last summer, world commodity prices have fallen sharply and that has helped drive a fall in overall CPI inflation from 5.2% in September to 3.2% in February. But the effect on UK consumer prices of decreases in world prices has been dampened by the depreciation of sterling. Since my December letter, the sterling effective exchange rate has depreciated by about 5%, bringing the total depreciation to 28% since the summer of 2007. February's inflation outturn is somewhat higher than expected. That could reflect pass-through of the exchange rate depreciation to consumer prices since much of the strength in the outturn appears to be concentrated in components where a large share of goods is imported.

Over what period does the MPC expect inflation to return to the target?

Despite the increase in CPI inflation in February, we believe that the sharp decline in CPI inflation since its peak in September is likely to resume in the coming months. This reflects two main factors.

First, a number of major gas and electricity suppliers have signalled a reduction in tariffs in response to earlier falls in global energy prices. On its own, we expect that this will act to reduce inflation in the coming months by around a percentage point. And there could be a further round of tariff reductions later in the year.

Second, the growth rates of money and nominal demand have slowed sharply. The contraction in economic activity in recent quarters has created a substantial margin of spare capacity in the economy. Output contracted by 1.5% in the fourth quarter of 2008 – a substantially larger contraction than the MPC expected in December. And indications suggest that the economy will contract at a similar rate in the first quarter of this year. This picture of very weak activity in the UK mirrors the pattern of demand in other countries: GDP contracted sharply in the Euro Area, US and Japan in the fourth quarter of 2008, and is likely to continue to fall in early 2009. And 54 out of 57 countries for which data are now available registered falls in industrial output in the fourth quarter of last year. In 32 of those countries, the fall was larger than that in the United Kingdom. The outlook for global activity will constrain UK demand prospects and, as a result, the margin of spare capacity is likely to build in the coming quarters, pulling down on CPI inflation. Consistent with that outlook, wage pressures are muted.

As a result of these factors, and notwithstanding the inflation outturn for February, it is likely that over the next year CPI inflation will move below target, although the profile of inflation could be volatile, reflecting the reversal of the temporary change in VAT on CPI inflation.

At its next policy meeting the MPC will want to consider further the extent to which the balance of risks has changed in light of the latest inflation figure and all the other relevant data. In particular, in the context of the CPI data this month, the Committee will need to judge to what extent the main upside risk to the inflation outlook identified in the February *Inflation Report* – that there is greater pass-through of the exchange rate depreciation to inflation – is crystallising, or whether the inflation outturn reflects other factors.

What policy action are we taking?

The MPC focuses on the outlook for inflation in the medium term because it takes time for monetary policy to affect the economy. As a result, current MPC actions could do little to affect the course of inflation during 2009. The Committee will look through temporary effects on inflation, such as the direct effects of the VAT change, and focus on ensuring that inflation remains on track to hit the target in the medium term.

Since I wrote to you in December, the Committee has lowered Bank Rate further from 2% to 0.5%. But given the substantial risks of undershooting the 2% CPI inflation target in the medium term, at its March meeting the Committee agreed that it was unlikely that the inflation target could be met solely by lowering Bank Rate and that alternative policy measures would be needed. As a result, the Committee voted to begin a programme of asset purchases financed by the issuance of central bank reserves. The aim is to boost the supply of money in the economy and hence raise the outlook for spending and inflation. The Committee judged that an initial programme of asset purchases of £75 billion was appropriate. At future meetings the Committee will monitor the effectiveness of the purchase programme.

How does this approach meet the Government's monetary policy objectives?

Price stability, as your remit to us states, is "a precondition for high and stable levels of growth and employment". By ensuring price stability in the medium term, the MPC will make its most effective contribution to economic performance more generally.

The Monetary Policy Committee remains determined to set monetary policy in order to keep inflation close to the 2% target in the medium term, thereby supporting growth and employment.

I am copying this letter to the Chairman of the Treasury Committee, through which we are accountable to Parliament, and will place it on the Bank of England's website for public dissemination.

Yours sincerely

Mervyn King